THE CHICAGO & ALTON CASE

A MISUNDERSTOOD TRANSACTION

BY GEORGE KENNAN

No episode, perhaps, in the career of the late E. H. Harriman has been more severely criticised, by the Interstate Commerce Commission, by certain members of Congress, and by an ill-informed part of the public, than the reorganization of the Chicago & Alton Railroad in 1899 and 1900. It excited little comment at the time, but when, long afterward, the Government began its campaign against Mr. Harriman, through the Interstate Commerce Commission, the transaction was characterized as "indefensible financing," and was described as the "crippling," "looting," and "scuttling" of a well managed and prosperous railroad by a syndicate of unscrupulous financiers in which Mr. Harriman was the "main conspirator." [1]

The Chicago & Alton Railroad, when Mr. Harriman became connected with it, was an apparently prosperous and well managed road. It had paid dividends of eight per cent on its invested capital for thirty years or more; its credit was good; and its shares of common and preferred stock were selling at from seventy-five to one hundred points above their par value. From a financial point of view it seemed to be as strong as any railroad of its class in the Middle West. Unfortunately, however, its managers had pursued an ultra-conservative policy in the matter of expenditures,

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[1] Reports of the Interstate Commerce Commission, vol. XII, pp. 301-303; Statement of Senator Cullom, *The Independent*, vol. 62, p. 692, Mar. 28, 1907; *Railroads: Finance and Organization*, by W. Z. Ripley, pp. 262-267.

and had neglected, for a long time, to make necessary appropriations to cover depreciation, and to provide for extensions, betterments, replacements, and additional equipment. The road had grown old without improving in physical condition; and had become more or less incapable of rendering the service demanded by a rapidly growing and developing territory. Speaking of this state of affairs, the well-known economist, Prof. E. S. Mead, says:

> The condition of the Alton was far below that of its competitors. . . . The standards of construction were those of fifteen years before. The track was laid with steel rails, but these were only seventy pounds to the yard. The bridges were in good condition, but were too light for heavy engines. The capacity of the sidings and second tracks was inadequate to handle large increase of traffic. . . . In short, the company had not maintained a sufficient depreciation account, and its property had not been kept up to standard.

According to J. H. McClement, expert accountant, who had occasion to investigate the affairs of the company,

> It had not added one mile of road in seventeen years. It had little or no reserve capacity to conduct a larger business. Its cost of operation, per unit of traffic, was very high in comparison with similar roads. Its grades were uneconomical. Its shops and equipment were uneconomical and old. Its settled policy against the expansion of its facilities, because of declining rates, was an absolute bar to the development of the tributary country. While for twenty-five years it had paid an average dividend of 8.3 per cent upon its capital stock, the gross earnings for the year 1898 [the year before Mr. Harriman became interested in it] amounting to $6,286,000, were the lowest since 1880, and had been gradually falling since 1887, when they amounted to $8,941,000. In many respects the company was being conducted like a commercial enterprise having in view ultimate liquidation, instead of like a public carrier.

The ultra-conservative—not to say parsimonious—policy of the management, the progressive deterioration in the physical condition of the road, and the decline of $2,655,000 in annual earnings in a period of ten years, naturally created dissatisfaction and excited a feeling of uneasiness among the owners of the company's securities, and in the fall of 1898, a number of the large stockholders, actuated by a feeling of apprehension as to the future of the road, requested

John J. Mitchell, President of the Illinois Trust Co., to open negotiations with Mr. Harriman, with a view to the sale of the property and a financial reorganization of the company.

Mr. Mitchell had an interview with Mr. Harriman in New York and represented to him that "many of the Alton stockholders were dissatisfied with the existing management; that the stock might be bought for less than the real value of the property; that if betterments and improvements were made and modern methods introduced the earnings might be largely increased; and that if control of the railroad were purchased, if funds for such betterments were provided, and if the road were developed, there would be an opportunity for a substantial profit." Mr. Mitchell also stated that he thought a majority of the Alton stockholders, if not all, would accept an offer of $175 a share for the common stock and $200 for the preferred. This, if all the stock were acquired, would make the road cost the purchasers nearly $40,000,000, a sum that would have to be paid in cash.

Mr. Harriman, who had never before thought of purchasing the Chicago & Alton, told Mr. Mitchell that he would take the matter into consideration, and ascertain as soon as possible the condition of the road. Shortly after this interview, Mr. Harriman requested Mr. S. M. Felton, a well-known expert and railroad manager, to make a thorough examination of the property, and submit a detailed report on its condition, requirements and earning capacity. Mr. Felton's report was favorable. He estimated that better management, and an expenditure of $5,200,000 for improvements and additional equipment, would enable the road to increase its earnings by at least $1,000,000 a year on the traffic then existing, to say nothing of the increased traffic that might be expected when the road should be able to afford adequate facilities to the then rapidly developing territory that it served.

Becoming satisfied that the road could be bought for less than its potential value, Mr. Harriman invited Jacob H. Schiff (of Kuhn, Loeb & Co.), James Stillman (President of the National City Bank) and George Gould, to join him in making the purchase on the terms suggested, and in providing the necessary funds for betterments and additional equipment, as well as for the refunding or retirement of the company's maturing bonds. Upon the representations made

by Mr. Harriman, Messrs. Schiff, Stillman and Gould agreed to co-operate with him, and the four men formed a syndicate for the purchase, reorganization and recapitalization of the Chicago & Alton road.

This syndicate was ultimately made to include Morris K. Jessup, John A. Stewart (ex-Assistant Treasurer of the United States), John J. Mitchell (President of the Illinois Trust Co.) and other individuals of like character, as well as some of the leading financial houses and institutions of the country. The supposition that men and firms of such standing would join a band of "pirates" and "looters" for the purpose of "wrecking" and "gutting" the Alton is, to say the least, highly improbable. The public assumed, or was led to believe, that Messrs. Harriman, Stillman, Schiff and Gould were the sole managers and beneficiaries of the reorganization; but this was not the case. The four gentlemen named organized the syndicate, but it included about one hundred members.

In January, 1899, the syndicate purchased ninety-seven per cent of the capital stock of the Chicago & Alton Company (about 218,000 shares) and paid therefor the sum of $38,815,000 in cash. They then proceeded to readjust the accounts of the company by crediting to surplus the sum of $12,444,000, which the old managers of the road, in previous years, had taken out of current income and invested in permanent betterments. In the opinion of the new owners and their legal counsel, permanent improvements and additions to the property ought to have been charged to capital account, and not taken out of surplus earnings, which belonged to the stockholders and which might properly have been distributed in dividends. The newly elected directors, therefore, charged to capital the sum of $12,444,000 previously spent in betterments, and credited it to surplus, with a view to distributing a part of it ($6,669,000) in the shape of a 30 per cent dividend on the old stock, and so lessening the cost of the road to its purchasers.

Having thus acquired the property, and transferred the cost of previous betterments to capital account, the syndicate, which included ninety-seven per cent of the stockholders, reorganized the corporation, and elected as President, in place of Mr. Blackstone, Mr. S. M. Felton, upon whose report the road had been bought. They then recapitalized the company by issuing securities in the following amounts:

50-year 3 per cent bonds.........	$31,988,000 [1]
50-year 3½ per cent bonds........	22,000,000
4 per cent preferred stock........	19,544,000
Common stock	19,542,000
Total	$93,074,000

The $31,988,000 of 3 per cent bonds actually issued were offered to all the stockholders and taken by them, pro rata, at 65, which was believed at the time and in the circumstances to be a fair rate. The purchase of these securities at a cost of $20,792,200 and the acquirement of 97 per cent of the stock of the old company, at a cost of $38,815,000, made the investment of the syndicate in the reorganized road $59,607,200. This sum was soon afterward increased by the purchase of the Peoria Northern line at $3,000,000 and the payment of $500,000 for commissions, charges, legal expenses, etc., in connection with the reorganization. This made the total investment of the new owners of the road $63,107,200.[2]

As soon as the sale of the bonds put sufficient money into the treasury, and made available the $12,444,000 of surplus created by capitalizing the sums previously spent in betterments, the new directors declared a cash dividend of 30 per cent on the old company's stock for the purpose of lessening the cost of the road to its buyers. This reduced the amount of their investment to $56,438,020.

To represent this sum, the new stockholders had in hand, for sale at the best prices they could get, stocks and bonds to the par value of $93,074,000.[3]

In order to get back the amount that they had actually put into the property ($56,438,020 as above shown) the stockholders would have to sell the bonds and preferred stock at approximately the following figures:

[1] Forty millions in 3 per cent bonds were authorized, but $8,012,000 were held in reserve for future requirements. These eight millions were subsequently sold at market rates and the proceeds were spent on the property.

[2] It is quite possible that the syndicate did not have this whole amount invested at any one time, because some of the securities may have been sold before the transaction was completed. The figures are given in this way only for the purpose of showing how much money the stockholders put into the venture from first to last.

[3] This capitalization was increased to $101,086,800, when the reserved bonds ($8,012,000) were issued. The total issue of 3 per cent bonds was then $40,000,000, instead of $31,988,000, as here stated.

$31,988,000	3 per cent bonds at 80..	$25,594,400
22,000,000	3½ per cent bonds at 74	16,280,000
19,544,000	preferred stock at 75..	14,658,000
	Total	$56,528,400
	Money invested	$56,438,020

They would then have the common stock as clear profit, and if they sold it at, say, 25, they would make about $5,000,000 on the purchase and recapitalization of the road. This would be equivalent to about 9 per cent on their total investment. They perhaps made more than this, but how much more it is impossible to determine. After the securities were distributed among the members of the syndicate, they were sold by the individual owners at various prices, and at various times between 1900 and 1907. The profit realized depended, in every case, upon market conditions at the date of sale.

Prof. Ripley states, as a fact, that the profits of the syndicate—that is, of the one hundred or more stockholders—were $23,600,000, but as he does not give his method of computation there is no possibility of testing his results. The Attorney General of Illinois figured that the syndicate made a profit of $24,648,600, but his calculations were soon discredited. Expert Accountant J. H. McClement showed that, even accepting the inordinately high prices at which the Attorney General assumed the stockholders sold, their profit was only $11,124,300. In other words, the figuring did not work out.

As a matter of fact, the computations of both Ripley and the Attorney General were mere guesses, made under the influence of a strong anti-Harriman bias. If the stockholders sold their securities at the average prices that prevailed between 1901 and 1907, they made $7,624,000. If they sold in the summer of 1903, when the control of the road was acquired by the Rock Island, they made $2,800,000. If they held on until 1907, and sold then, they lost $1,400,000. (McClement, pp. 13-14 *et seq.*) The probability is that most of the stockholders sold at the most favorable time—*i.e.*, in the first year, or the first two years, after the securities were distributed. By an Act of the New York Legislature, approved February 26, 1900, the 3 per cent bonds of the

Chicago & Alton Railroad Company were made a legal investment for the savings banks of that State, and this immediately created a good demand for them at prices that ranged from 82½ to 94. As there is no means, however, of ascertaining when the hundred or more stockholders disposed of their holdings, or what prices they obtained for them, it is impossible to know what their profits were, and for that reason all estimates are more or less conjectural. The most that can be said with certainty is that those who happened to sell at top prices realized more than they had anticipated.

The results of the reorganization, so far as the stockholders were concerned, may be summarized in the statement that they invested $56,000,000 or $57,000,000 in the property (including the purchase of the 3 per cent bonds); expanded the capitalization by issuing new securities to the par value of $93,074,000 (excluding the $8,012,000 reserved for betterments); and finally sold these securities at prices which gave them a net profit of probably eight per cent and possibly twelve or fifteen per cent upon the cash outlay.

At the time when the road changed ownership, the series of transactions above outlined excited little if any adverse criticism. Every detail of the reorganization, including the 30 per cent dividend and the sale of the 3 per cent bonds to the new stockholders at 65, had the widest possible publicity; but nobody complained of injury or injustice. The former owners of the road were satisfied with the price that they received; the 3 per cent of the old stockholders who declined to sell their shares enjoyed the same rights and privileges that were accorded to the new stockholders; the ultimate purchasers of the new securities bought with full knowledge of the syndicate's operations, and did not complain that they had been either misinformed or misled; the governors of the New York Stock Exchange considered all the details of the recapitalization and then listed the new securities without objection or question; and, finally, the patrons of the road were more than satisfied with the lower rates and greatly increased facilities that they enjoyed under the new management.

Serious and hostile criticism of the Chicago & Alton reorganization did not begin until 1906—seven years after the Harriman syndicate bought the road. In the Fall of that year, the friendly relations that had previously existed be-

tween President Roosevelt and Mr. Harriman were broken off as the result of a disagreement, or misunderstanding, with regard to a contribution made by Mr. Harriman to the Republican campaign fund, just prior to the Presidential election of 1904. Mr. Harriman thought that the President had failed to observe the terms of a mutual understanding with regard to the best means of promoting the interests of the party in New York; and when, in the Fall of 1906, he was asked by James S. Sherman (Chairman of the Republican Congressional Committee) to make another contribution, he declined to do so, for the alleged reason that the President had not kept faith with him. His refusal was made known, of course, to Mr. Roosevelt—probably with an unfair or inaccurate statement of the reasons for it—and the President, resenting the imputation of unfaithfulness, assumed toward Mr. Harriman an attitude of hostility, and characterized him, in a letter to James S. Sherman, as " an undesirable citizen." Five or six months later—in April, 1907—a discharged stenographer who had formerly been employed by Mr. Harriman dishonorably sold to the *New York World* an imperfect copy of a private letter written by Mr. Harriman to one Sidney Webster of New York. In this letter Mr. Harriman set forth his understanding of the campaign contribution episode, together with his reasons for believing that the President had treated him unfairly. (*New York World,* April 2, 1907). The publication of the letter led to a somewhat acrimonious newspaper controversy, in which Mr. Roosevelt denied and Mr. Harriman reaffirmed the accuracy of the statements made therein.

It may be only a chronological coincidence, but it was in the Fall of 1906, soon after the rupture of friendly relations between the President and Mr. Harriman, that the Interstate Commerce Commission, acting either on its own initiative or upon suggestion, began an investigation of the " undesirable citizen's " past activities; and it was on the 5th of April, 1907, three days after the publication of the Webster letter, that the record of the investigation was submitted to the Commission for judgment.

The official statement of facts included, of course, the Chicago & Alton reorganization, which was described by the Commission as " indefensible financing." The features of the transaction most severely criticised were the dividend of 30 per cent on the stock of the old company; the selling of

the 3 per cent bonds to the new stockholders at 65; and the inflation of the capitalization. It will be most convenient, perhaps, to take up these transactions in the order in which they have been mentioned.

1. The 30 per cent dividend.

That the new stockholders had a legal right to charge to capital the cost of permanent betterments which had previously been charged to income is unquestionable. The practise had not only the approval of expert accountants, but the sanction of the courts. In a precisely similar case in England, the High Court of Appeal said:

> The circumstance that they had been paying what ought to be charged to capital out of revenue does not prevent their right, or their duty to the persons who are looking for their payment out of revenue, to credit back to revenue those things which have been carried, for the time being, to capital account. (Mills vs. Northern Railway Co., 5 Chancery Appeals, 621).

The new stockholders also had a legal right to transform the book surplus thus obtained into an actual cash surplus by selling bonds to the necessary amount, and then to declare a cash dividend from the surplus so obtained. W. W. Cook, the standard authority on corporation law, says:

> When the company has used profits for improvements, it may lawfully borrow an equivalent sum of money for the purpose of a dividend. And it may properly borrow money to pay a dividend, if, upon a fair estimate of its assets and liabilities, it has assets in excess of its liabilities, and capital stock equal to the amount of the proposed dividend. (Cook on Corporations, 5th edition, section 546.)

In paying a dividend of 30 per cent out of a surplus created by capitalizing the cost of previous betterments, the new management was only doing what the old management had intended to do. In a circular letter to the old stockholders, written in February, 1899, T. B. Blackstone, then President of the Chicago & Alton Railroad, said:

"In case a majority of the shares of the company are not sold to the syndicate, I shall advise that you authorize the refunding of the outstanding bonds of the company, and the issue of a stock dividend to represent earnings heretofore invested in permanent improvements." His reasons for making this recommendation were not only that large sums had previously been expended in permanent improvements which ought to have been charged to capital, but that, partly

as a result of this policy, the existing capitalization (bonds and stock together) represented less than 60 per cent of the actual cost of the property. (Report of President Blackstone for 1894). Inasmuch as this undistributed surplus from past earnings was mainly responsible for the high price that the purchasers had to pay for the old stock ($175 and $200 per share) they naturally thought that they were justified in taking out of such surplus a part of the purchase money. That it rightfully belonged to them there can hardly be a question. W. M. Ackworth, the leading European authority on railway administration, says, in a recent review of William E. Hooper's *Railway Accounting:*

"Here in England, no one has yet doubted that undivided profits, put back into the business, belong to the stockholders just as much as the property purchased with the capital originally subscribed."

In view of these considerations, it is hard to see why it was not proper, as it unquestionably was legal, to declare a dividend of 30 per cent on the old stock for the purpose of lessening the cost of the road to its buyers.

2. The issue of $31,988,000 of 3 per cent bonds to the new stockholders at 65.

It was perfectly proper, and in accordance with the general practise, to offer the new bonds to the stockholders before offering them to the public. The stockholders had taken the risk of putting $38,815,000 into the property, in cash, and it was only just that they should have the first chance to buy the securities issued by the new company upon reorganization. "But," it may be said, "the price at which the bonds were offered was too low. It enabled the buyers to resell them at a great advance, and thus to realize a profit which ought to have gone into the treasury of the company." That the stockholders did make a large profit when they resold the bonds is unquestionable; but that the price at which they acquired them was too low, measured by the standards and conditions of the time, is not so certain. A 3 per cent bond was then an untried experiment. The bonds of the old company, which were about to mature, bore interest at 6 and 7 per cent and nobody could tell in advance what the market value of a low-rate security would prove to be. That the price at which the 3 per cent bonds were offered to the stockholders was low enough to give them a chance of profit is true; but there was no intention of giving them an exorbitant

profit. A market for bonds bearing as low an interest rate as 3 per cent had to be created. Such securities would naturally be taken by savings banks; but the bill making the bonds of the Chicago & Alton Company a legal investment for New York savings banks had not then passed the legislature, and it was uncertain whether it would pass. If it did not, the demand for such bonds would be comparatively limited, and they might not bring more than 70, at which price they would yield 4.28 per cent. The bill which authorized New York savings banks to invest in Alton bonds, and which thus created a market for them, did not become law until February 26, 1900, more than a year after the syndicate bought the road. It was then signed by Theodore Roosevelt, Governor of the State, who apparently thought that the bonds of the "looted," "wrecked" and "gutted" corporation were a safe investment for savings banks.

In 1907, when the Interstate Commerce Commission investigated the subject, these very bonds were selling for only a little more than the price at which they were issued, although they were just as good then as they ever had been. The exceptionally high prices from which the stockholders profited, or may have profited, in 1901-1902, were purely fortuitous, and were due mainly to the state of the money market, the low rates of interest which then prevailed, and the almost unprecedented demand for investment securities.

It must not be forgotten, moreover, that in investing cash to the amount of $20,800,000 in 3 per cent bonds, the stockholders took all the chances of interest rates, State legislation, and savings bank demand, and that such chances might have gone against them. They ran risks and reaped profits, and there was little if any criticism of their action until seven years later, when the Government, through the Interstate Commerce Commission, began its campaign against that "undesirable citizen," E. H. Harriman.

So far as this particular transaction is concerned, the Federal authorities might, with equal reason, have begun proceedings against other railroad companies. In April, 1899, the Chicago, Burlington & Quincy sold to its stockholders at 75 three-and-a-half per cent bonds which went soon afterward above par; and some years earlier the St. Paul, Minneapolis & Manitoba sold to its stockholders at 10 an issue of mortgage bonds which later went above 100. It was at that time a frequently employed and never contested

practise to give " rights " to stockholders by offering them stocks or bonds at prices below their actual or possible value, and it is still a common practise in other fields of business enterprise.

3. The alleged over-capitalization.

The question whether the Chicago & Alton was over-capitalized or not—that is, whether its capital stock exceeded its potential value—depends largely upon the definition given to the word " value." What is the value of a railroad? To this question three different answers have been given, namely:

(a) The value of a railroad is to be measured by the amount of money actually invested in it, from first to last.

(b) The value of a railroad is the present cost of reproducing and equipping it, as new.

(c) The value of a railroad is the sum on which, as a " going concern," it can earn at least the current rate of interest.

The Interstate Commerce Commission seems to prefer the first of these definitions; some economists favor the second; and most railroad men adopt the third. Outside of the Commission, the opinion is widely held that the value of a railroad, like that of income-producing property in any other form, is dependent upon its use, and is to be measured by the net earnings arising from such use. This was the view taken by the veteran railway manager, Henry Fink, in his letter to the Railroad Securities Commission; by Thomas L. Greene, Vice President of the Audit Co. of N. Y., in his *Corporation Finance;* by Judge Hook, in the Oklahoma case; and by the United States Supreme Court in the case of the C. C. C. & S. L. Ry. Co. vs. Backus. In the case last named the Court said: " Never was it held that the cost of a thing is the test of its value." . . . " The value of property results from the use to which it is put, and varies with the profitableness of that use, present and prospective, actual and anticipated."

Assuming then, or rather adopting the view of competent authorities, that the value of a railroad, and consequently its proper capitalization, should be based on earning capacity, " present and prospective, actual and anticipated," was Mr. Harriman justified in believing that he could pay $3,533,449 annually, in interest and dividends, on a capitalization of $101,000,000?

In the year when the syndicate bought the Chicago & Alton, the road, even in its run-down and half-equipped condition, earned $2,684,694 net, and it had earned, on an average, $2,734,534 net for the six preceding years (1893 to 1898, both inclusive). It was only necessary, therefore, that annual net earnings should be increased by $798,906 in order to pay interest and dividends on all outstanding securities.[1] Mr. Felton, a thoroughly competent judge, estimated that by an expenditure of $5,200,000 in betterments the annual net earnings of the road might be increased at least $1,000,000. Mr. Harriman, an even better judge, believed that improvements and better management would bring the annual net earnings up to $4,000,000. This would not only pay all fixed charges and dividends on both classes of stock, but would leave a net annual surplus of $467,000. How prudent and conservative these estimates were the results showed. In the year when the Interstate Commerce Commission investigated the recapitalization, the net earnings of the road were $4,415,974, a sum which was $415,974 above Mr. Harriman's estimate, and $681,440 above the estimate of Mr. Felton. If rates had not been reduced during the period of Mr. Harriman's administration, the increase in net earnings would have been even greater than this.

A case parallel in some respects to that of the Chicago & Alton is furnished by the reorganization of the Norfolk & Western Railroad in 1896. In 1895, before the reorganization and recapitalization, the road and equipment were valued at $115,098,721, and the capitalization was $117,364,909, as follows:

Bonds	$57,864,909
Preferred stock	50,000,000
Common stock	9,500,000
Total capitalization	$117,364,909

In reorganization the bonds were increased by $4,635,000 and the common and preferred stock by $30,000,000, making an expanded capitalization of $151,999,909 (*Commercial & Financial Chronicle,* vol. 62, 1896). In commenting on this

[1] Owing to the necessity of spending for betterments four times the original estimate, the capitalization was ultimately increased to about $114,000,000, but I am dealing here only with the capitalization of $101,000,000, upon which the plans of Mr. Harriman and the syndicate were based.

inflation, which amounted, as above shown, to nearly $35,000,000, President Fink said: " Stocks issued in such cases are in no sense fictitious. They represent actual value and are drafts, for value received, on more prosperous times."

He then shows that although the Norfolk & Western was over-capitalized in 1896, in the sense that it was not then earning dividends and fixed charges, it did begin paying dividends on the preferred stock in 1897 and on the common in 1901 (" Over-Capitalization," by Henry Fink; *Railway Age Gazette,* July, 1908, p. 16). The present market value of its stock is 119, which shows that its earning capacity has much more than overtaken its capitalization, notwithstanding the $35,000,000 inflation.

Mr. Harriman expected to do with the Chicago & Alton just what Mr. Fink did with the Norfolk & Western, viz., increase by means of extensive betterments its capacity for doing business and its earning power, and thus bring its net operating revenue up to the requirements of its enlarged capitalization. That he measurably succeeded in doing this is shown by the fact that when, after losing control of the road in 1903, he completely severed his connection with it in 1907, it was paying 4 per cent on its preferred stock and earning 5 per cent on its common. In other words, it was taking care of its entire capitalization, and was doing this with no increase in rates, and with an enormous extension of its facilities for transacting business and serving the public. These facts, however, as well as many others, were suppressed or ignored in the Interstate Commerce Commission's report. The Commissioners, from their point of view, might have been justified in expressing disapproval of Mr. Harriman's methods; but they were not justified in concealing the fact that these methods had more than doubled the capacity of the road to serve the people. " *Suppressio veri, suggestio falsi,*" and the concealment in this case gave the impression that Mr. Harriman, in the words of Senator Cullom, had " looted the road," regardless of the interests of the people and the territory that it served. The rebuilding of the Chicago & Alton was one of the great railroad achievements of the time; but in the report of the Interstate Commerce Commission it is made to appear a piratical raid of unscrupulous financiers, who, for their own selfish purposes, wrecked and gutted a well conducted and prosperous corporation. If the Commissioners could be

examined, as Mr. Harriman was, under oath to tell "the *whole* truth," they might find it difficult to explain why, in a report that was supposed to cover all the facts essential to an understanding of the case, they said nothing with regard to the physical condition of the Alton when the Harriman syndicate bought it; nothing about the intention of the old management to declare just such a dividend as that declared later by the new management; nothing about the sanction given by the courts and legal authorities to the capitalization of past betterments; nothing about the general practice of the time in the matter of reorganizations; nothing about Mr. Harriman's virtual reconstruction and complete re-equipment of the road; nothing about the increase of 90 per cent in gross earnings and 80 per cent in net earnings which resulted therefrom; nothing about the lowering of rates and the improvement of facilities; nothing about the relation between the earning capacity of the reorganized road and its expanded capital, and nothing about the resumption of dividends on its preferred stock in 1906. A report which conceals or ignores these pertinent facts is not a judicial review of the case, but merely a prosecuting attorney's brief.

The responsibility for the present condition of the Alton cannot justly be thrown upon Mr. Harriman. The control of the road was wrested from him by the Rock Island, while he was in Europe in 1903, and he severed his connection with it altogether when the Rock Island transferred its holdings to the Chicago, St. Louis & Western in 1907. The financial measures adopted by the later management were ill-advised and unfortunate, and never would have met Mr. Harriman's approval. Partly to these measures, and partly to regulation, low rates, and depressed business conditions, the present difficulties of the road are due. When Mr. Harriman resigned, the Alton was not only paying its fixed charges, but was earning more than 4 per cent on both classes of its stock.

Before concluding this review of the Chicago & Alton reorganization, it seems necessary to answer specifically certain charges made against Mr. Harriman by two men who occupy positions of responsibility or authority, namely, Interstate Commerce Commissioner Prouty and Professor William Z. Ripley of Harvard University.

In an address delivered before the National Association of Manufacturers, in May, 1907, Commissioner Prouty said:

"When Mr. Harriman, by dealings like those in the Chicago & Alton, enriches himself to the extent of many millions, he has not created that money. He has merely transferred it from the possession of some one else to himself." (*Independent*, New York, May 30, 1907, p. 1129.)

In the first place, there is no evidence to show that Mr. Harriman, as an individual participant in a syndicate of one hundred members, enriched himself to the extent of "many millions."

In the second place, it may controversially be said that when the Interstate Commerce Commissioners, by drawing money in the shape of salaries from the people of the United States, enrich themselves to the extent of many hundreds of thousands of dollars, they have not created that money. They have merely transferred it from the possession of some one else to themselves. They may reply that for the money they have "transferred" from the people, through the United States Treasury, to themselves, they have rendered valuable services—in other words, they have earned it. Mr. Harriman might have said the same, and with much more reason. By his "dealings" in the Chicago & Alton he almost entirely rebuilt the road; doubled its passenger accommodations; improved immensely its train service; increased by 134 per cent the hauling power of its locomotives, added 269 per cent to its capacity for moving freight; fostered old industries and created new ones all along its line; and enabled the people of Illinois to "create" tens of millions of dollars which they never could have created without the traffic facilities given to them by Mr. Harriman's betterments. And all this was accomplished not only without an increase in rates but with an actual reduction. If the Interstate Commerce Commissioners could show anything like this equivalent for the money that has been "transferred" from the U. S. Treasury to themselves, their claim to have earned their salaries would be unquestioned and unquestionable. Unfortunately, in the judgment of many thinking people, they have injured the business of the country instead of promoting it, and by their cramping over-regulation of railroads have alarmed investors, frightened away capital, and prevented the construction of thousands of miles of new roads, which the country already needs, and will need still more urgently in the near future. In the judgment of competent observers, they have also forced into bankruptcy

dozens of railroads which were not mismanaged, and which might have met all their obligations if the Commission had allowed them to make their rates high enough to cover increased taxes, increased wages, and the largely advanced cost of materials and equipment. Eighty-two railway corporations are now in the hands of receivers, and even Mr. Prouty will hardly contend that they have all been "wrecked," "looted," or financially mismanaged, by "unscrupulous financiers." Most of them have failed simply because the policy of the Commission has impaired the credit of railway corporations generally, and made it impossible for weak roads to sell their securities on advantageous terms. Investors will not buy such securities until they have a reasonable assurance that the Commission will allow the companies to earn fixed charges and dividends. It seems, therefore, to be at least a debatable question whether the Commission has not "wrecked" more railroads than unscrupulous financiers have.

One of the most unfair, as well as one of the most recent, of Mr. Harriman's assailants is Professor William Z. Ripley, Ropes Professor of Economics in Harvard University. In a volume entitled *Railroads: Finance and Organization,* Prof. Ripley devotes a part of his eighth chapter to the Chicago & Alton recapitalization, and begins his account of it in the following words:

"Practically all of the possible abuses or frauds described in the preceding pages are found combined in a single instance in recent years—the reorganization of the Chicago & Alton road by the late E. H. Harriman and his associates during the eight years following 1898."

Most of the hostile critics of the Chicago & Alton transaction try to make their points by concealing or ignoring facts favorable to the defense. Prof. Ripley not only conceals or ignores but misstates. He says, for example (p. 263), that the Alton road, prior to its reorganization, was doing "a constantly expanding business." This, simply, is not true. The reports of the company show that its earnings had been stationary for five years and had fallen about 30 per cent in eleven years. The precise figures are given by Director Thompson, of the Bureau of Railway Statistics, in his *Cost, Capitalization and Estimated Value of American Railways*, p. 183.

Prof. Ripley states repeatedly (pp. 264 and 265) that

the operations of Mr. Harriman and the syndicate were "covered up," "remained undisclosed," "were never disclosed," "were obscured in the published accounts," and "were thoroughly concealed." This, again, is simply not true. All the operations of Mr. Harriman and the syndicate, including the 30 per cent dividend and the sale of the 3 per cent bonds to the stockholders at 65, were fully and accurately set forth in the listing application to the Stock Exchange, as well as in the leading financial publications of New York, including, among others, *Poor's Manual, Moody's Manual,* and the *Manual of Statistics,* for 1900 and 1901; the New York *Evening Post,* the *Wall Street Journal,* and five issues of the *Commercial & Financial Chronicle* between April 1 and November 17, 1900.

Prof. Ripley accuses Mr. Harriman of "prejudicing the interests of shippers by creating the need of high rates for service in order to support the fraudulent capitalization." This charge is doubly misleading. In the first place it erroneously assumes that rates are dependent upon capitalization; and in the second it suggests that Mr. Harriman did raise rates on the Alton in order to bolster up fictitious securities. Neither the assumption nor the suggestion is supported by the facts. High capitalization, as a rule, does not result in high rates. On the contrary, the lowest average freight rates are in the parts of the United States which have the highest railroad capitalization.[1]

That there is no interdependence of capitalization and rates has been repeatedly admitted, even by the Interstate Commerce Commission. As long ago as 1899, Chairman Martin A. Knapp testified before the Industrial Commission that he had never seen a case in which rates seemed to depend upon capitalization, or be influenced by it. "The capitalization of a railroad," he said, "cuts no figure in this rate question."

In an article entitled "Railroad Capitalization and Federal Regulation," Franklin K. Lane, while he was yet Commissioner, said:

"Fundamentally, there is no interdependence of capitalization and rate. The latter is not in law, nor in railroad policy, the child of the former."

The statement that the "unscrupulous management" of

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[1] *The Railroad Situation of To-day,* by Frank Trumbull.

the Chicago & Alton did, as a matter of fact, " increase rates for service in order to support the fraudulent capitalization " is not true. The freight records of the Chicago & Alton for the period in question show a slight reduction in rates on grain, live stock, merchandise, and other classified commodities, with a very substantial reduction on coal. In 1899, the through rate on coal from the Springfield district was 80 cents. In 1907 it fell as low as 40 cents. The average rate per ton per mile on the whole traffic (including coal) was reduced, as Director Thompson has stated, about 25 per cent.

The most surprising of all Prof. Ripley's misstatements is that which charges Mr. Harriman with " crippling " the Alton road " physically " (p. 262). Mr. Frank H. Spearman, who has made the rebuilding of the Alton the subject of a special article, says: " Mr. Harriman overhauled the system completely, and put it physically a little in advance of every competitor." He not only lowered grades and straightened curves everywhere, but relaid about 500 miles of track with heavier steel rails, and built, in four years, no fewer than 318 new steel bridges, including the great structure that now spans the Missouri. Having thus made the track capable of sustaining heavier equipment, he substituted 165-ton locomotives of the " consolidation " type for the 55-ton engines previously in use, and reduced the ratio of car-weight to car-load about one third, at a single stroke, by " scrapping " the old wooden cars of 25-ton capacity and putting in their places steel gondolas with a freight capacity of 55 tons. He also equipped the road with new and more spacious passenger coaches, and provided passenger trains with exceptionally large locomotives, two of which, at that time, were the most powerful express passenger engines in the world. He wholly eliminated grade crossings in Chicago; equipped long stretches of track with continuous, interlocking electric signals; and introduced for the protection of trains the most effective safety devices that could be found.[1]

According to Prof. Ripley, the nefarious purpose of the " main conspirator " in making all these improvements was to " cripple the road physically " !

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[1] "The Rebuilding of an American Railroad," by Frank H. Spearman, in *The Strategy of Great Railroads*, pp. 50, 223, 225-6.

During the period of Mr. Harriman's administration, he spent $11,262,763 on roadway and structures, and $11,064,-454 on new equipment, making a total of $22,327,219 for permanent betterments, a sum equivalent to about $22,000 per mile. The road thus "physically crippled" increased its gross earnings from $6,286,569 in 1898 to $12,809,426 in 1907, and its net earnings from $2,684,694 to $4,415,974. How it was able to do this, in its "physically crippled" condition, Prof. Ripley does not explain.

Those who have made a serious study of Mr. Harriman's activities know that he never crippled a railroad physically in his life. On the contrary, he never touched a railroad that he did not physically improve. From the Sodus Bay & Southern to the Union Pacific and the Alton, he made every railroad that he controlled serve the public better than it had ever served it before. No railroad corporation, moreover, ever defaulted on its bonds, or failed to earn its fixed charges, under Mr. Harriman's management. (Hearings before the Interstate Commerce Commission in the C. & A. case, p. 73.)

It is not easy to characterize Prof. Ripley's statements fittingly without overstepping the bounds of controversial courtesy; but inasmuch as he, himself, has not hesitated to call Mr. Harriman a "conspirator," and to describe his management of the Chicago & Alton as "unscrupulous," "piratical," "fraudulent" and "predatory," it may perhaps be proper to say, in the form, although not quite in the words of the professor's opening sentence: "Practically all of the possible methods, described in previous pages, of making a thing seem that which it is not, are found combined in a single instance in recent years—the account of the reorganization of the Chicago & Alton Railroad, by William Z. Ripley, Ropes Professor of Economics in Harvard University."

GEORGE KENNAN.